



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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March 27, 2012

VIA INTERNET

KRISTINE CAZADD
Executive Director

Dear Interested Party:

The Audit Manual (AM) is a guide for the Board of Equalization (BOE) staff in administering tax and fee programs. It is available to the public and can be accessed from the BOE web page at <http://www.boe.ca.gov/sutax/staxmanuals.htm>.

The Sales and Use Tax Department (SUTD) is proposing to revise AM Chapter 4 sections 0405.20, 0405.33, 0409.51 and 0435.20, and delete page 2 of Exhibit 6, to incorporate current policies and procedures. The revision material is provided on the following pages for the convenience of interested parties who may wish to submit comments or suggestions. Please feel free to publish this information on your website or otherwise distribute it to your association/members.

If you have any comments or suggestions related to the proposed AM revisions, you may contact the BOE at [AM RevisionSuggestions@boe.ca.gov](mailto:AMRevisionSuggestions@boe.ca.gov). Your comments or suggestions must be received by BOE no later than **May 27, 2012** in order to be considered by staff. Thank you for your consideration.

Sincerely,

Susanne Buehler, Chief
Tax Policy Division
Sales and Use Tax Department

USE OF TEST BASIS

0405.20

There are two broad categories of testing used in sales and use tax auditing. The preferred category is statistical sampling, which is covered in detail in Chapter 13, [*Statistical Sampling*](#). The second category of testing used when statistical sampling cannot be used is block sampling and related methods. This section focuses on block sampling and related methods.

An audit made on a test basis is one in which the transactions of only a part of the audit period are examined in detail. The balance of the period is adjusted on the basis of the findings in the test periods. Such findings are usually expressed in terms of percentages of error calculated from the errors and differences disclosed in the test period. This basis assumes that the differences disclosed in the test period, which are audited in detail, will occur in the same proportion in the balance of the audit period.

[Errors in block samples should be projected even if the errors are from the same customer or vendor when the sample is representative of the business for the time period in question. This applies even when there are three or fewer errors. Auditors must justify their decision to project or not to project the errors in the verification comments. This is especially important when projecting a block sample with fewer than three errors.](#)

USE OF PRIOR AUDIT PERCENTAGES OF ERROR IN CURRENT AUDITS 0405.33

The prior audit percentages of error (PAPE) program involves the use, under certain circumstances, of a percentage of error developed in a prior audit for the sales or accounts payable portion of a current audit.~~The techniques used in the prior audit to calculate the percentages of error will not preclude the use of the prior audit percentage; however, other factors, as noted below, must be taken into consideration before approving the use of the prior audit percentage in a current audit.~~It can be a valuable tool in streamlining the audit process. It is designed to reduce the time it takes to complete an audit and minimize the burden on taxpayers.

~~Each district office will identify taxpayers currently under audit or selected for audit with at least one prior audit.~~

When planning the audit, supervisors and auditors should evaluate whether the taxpayer is eligible for the use of a PAPE. This evaluation should be conducted whether or not the taxpayer has already requested the use of a PAPE. If the taxpayer is eligible for the use of a PAPE, the auditor should discuss the PAPE with the taxpayer as soon as possible rather than wait for the taxpayer to request using a PAPE. The date of the discussion and the taxpayer's response should be documented on Form BOE-414-Z, *Audit Assignment History*. A decision that the taxpayer is not eligible should also be explained and documented on Form BOE-414-Z.

To qualify for the PAPE, the taxpayer must have at least one prior audit and must meet the conditions discussed in this section. The most recent prior audit and the current audit must indicate consistent operations, volume, and potential type of errors.~~Once these taxpayers have been identified, limited~~ Limited testing of the taxpayer's records and internal controls will be necessary in order to determine whether there have been any changes to the taxpayer's operations since the last audit. Such testing should include an examination of source documents, such as invoices and paid bills, for changes in processing procedures ~~of such~~ since the last audit. Other changes to look for include:

~~Other changes to look for include:~~

- 1 ~~The n~~ Nature of their business
- 2 ~~Their a~~ Accounting procedures
- 3 Key personnel or turnover of staff
- 4 New or revised ~~L~~ laws or regulations affecting their business
- 5 Significant increases in the population being sampled

If limited testing discloses some change(s) to the taxpayer's operations, the auditor should take into consideration the materiality of the change(s) and whether or not a PAPE can still be used for a portion of the audit period or the area being tested. If the change(s) in the taxpayer's operation is minor, the risk of underestimating the audit results by applying a PAPE may be small. It is important to remember that the use of a PAPE is limited to the current audit period as a PAPE cannot be used in two subsequent audits and therefore will not create a basis for RTC section 6596 relief in

a subsequent audit.

The techniques used in the prior audit to calculate the PAPE will not preclude its use in the audit; however, other factors, as noted above, must be taken into consideration before approving the use of the PAPE in the current audit.

To be representative, if stratified dollar limitations were used in the last audit, generally the same dollar stratification should be used in the current audit. However, if there is an indication during the limited testing that a different stratification level may be appropriate in the current audit, the new stratification level should be used. If so, the prior percentages of error will have to be adjusted to reflect the new stratification level. percentage of error to apply to the current audit will be calculated by combining multiple strata from the prior audit. To compute the single percentage of error for a specific area tested in the prior audit, divide the total measure of errors by the population.

~~For example, a decrease or increase in the stratification level will affect the sample base (by deleting or including sample items), the population base (by deleting or including population items) and the percentage of error (by deleting or including error items) in the prior audits. These recalculations must be made so that the proposed percentage of error to be used in the current audit is an accurate representation of the prior audit percentages of error at the new stratification level.~~

~~This information should then be used by the District Principal Auditor and audit supervisor to evaluate such taxpayers for inclusion in this program.~~

~~Those taxpayers meeting the criteria described above should then be contacted and informed of the program by an auditor and audit supervisor. The taxpayer must also be informed that this procedure will not be used in consecutive audits.~~

For example, if claimed exempt sales were sampled using stratified dollar limitations in the prior audit, the single percentage of error (recomputed PAPE) is the ratio of the total measure of disallowed exempt sales to the total claimed exempt sales, in the prior audit. The total measure of errors (numerator) can be obtained from the audit work papers' lead schedule, the front of Form BOE-414-A, *Report of Field Audit*, or IRIS. The total population of claimed exempt sales (denominator) can be obtained from Form BOE-414, *Transcript of Return Filed-Sales and Use Tax* or in the prior audit work papers. The recomputed PAPE in this example is then applied to the quarterly claimed exempt sales for the current audit period, which are generally available on Form BOE-414.

After discussing the ~~discussion~~ use of a PAPE with an eligible ~~taxpayers~~ taxpayer(s), a detailed outline memo from the Audit Supervisor to the District Principal Auditor (DPA) (Exhibit 6, page 1) should be prepared for each interested taxpayer indicating why they would make a good candidate for inclusion in this program (Exhibit 6). Each outline should include:

- (a)- Name and, account number, case Id and NAICS code of the eligible taxpayer
- (b)- Nature of taxpayer's business
- (c)- Current audit period

- (d)- Portion(s) of audit where a prior percentage of error is to be used
- (e)- Prior audit periods and corresponding percentages of error for those portion(s)
- (f)- Population(s) to which the prior percentage(s) of error was applied
- (g)- Proposed percentage of error to be used for the portion(s) in the current audit
- (h)- Population(s) to which the proposed percentage(s) of error will be applied in the current audit
- (i)- Any other pertinent information

The memo outline should be approved by the ~~District Principal Auditor~~ DPA and maintained in the audit as a memo schedule. ~~Upon completion of the audit, the district will prepare an evaluation memo (Exhibit 6, page 2) to the Chief, Tax Policy Division with a copy to the Chief, Field Operations Division, Equalization Districts 1 and 2 and Out of State District, or the Chief, Field Operations Division, Equalization Districts 3 and 4 and Centralized Collection Section.~~

~~The evaluation memo must include the tax change of the portion(s) of the audit utilizing the prior percentage of error along with an estimate of the number of audit hours saved. A copy of the outline memo should be attached to the evaluation memo.~~

Upon the DPA's approval of a PAPE, the DPA (or designee) will enter basic information on the account into the District Reports Data Base (DRD). Basic information includes:

- Account Number
- Case ID
- Taxpayer Name
- Auditor Name
- Industry Type (NAICS)
- Audit Period
- "Area" that PAPE will be applied to
- Approval date by District Principal Auditor

In addition, immediately after the audit has been transmitted to headquarters, the DPA (or designee) will enter the remaining detailed information regarding the outcome of using the PAPE into the District Reports Data Base (DRD). This information will include:

- Tax for "Proposed" PAPE assessment
- Estimated Hours Saved
- Total Audit Hours
- Transmittal date

The auditor must ensure that the taxpayer understands that any of the above other evidence by itself is not the equivalent of a resale certificate timely taken in good faith, and may not relieve the seller of the liability for the tax.

In [the](#) absence of any valid resale documentation, the auditor may determine that it is appropriate for a seller to use the Form BOE-504 series of forms (hereafter called “XYZ” Letters) procedure to help satisfy their burden of proving that a sale was not at retail even though a valid resale certificate was not obtained or to substantiate a claim that their customer paid the tax directly to the state. Copies of the forms are available on eBOE.

The “XYZ” Letter procedure utilizes the following forms:

- [BOE-504-A](#), explains the “XYZ” Letter procedure
- [BOE-504-A1, explains the “XYZ” Letter procedure \(email version\)](#)
- [BOE-504-B](#), Sample “XYZ” Cover Letter
- [BOE-504-B1, Sample “XYZ” Cover Letter \(email version\)](#)
- [BOE-504-C](#), Statement Concerning Property Purchased Without Payment of California Sales Tax, for use when auditing in-state sellers
- [BOE-504-C1, Statement Concerning Property Purchased Without Payment of California Sales Tax, for use when auditing in-state sellers \(electronic version\)](#)
- [BOE-504-COS](#), for use when auditing out-of-state sellers
- [BOE-504-CLS](#), for use when questioning sales made to leasing companies
- [BOE-504-BPA](#) and [BOE-504-CPA](#), for use when questioning ex-tax sales of special printing aids (also see AM section 1103.30)
- [BOE-504-CFS](#), for use when questioning ex-tax sales of feed, fertilizer, seed or annual plants
- [BOE-504-CUS](#), for use when questioning ex-tax sales made to U.S. Government supply contractors

[Forms BOE-504-A1, B1 and C1 provide electronic mailing and receipt capabilities. These forms are for use by taxpayers who would like to send XYZ letter inquiries to their customers electronically. Form BOE-504-A1 summarizes the procedure to obtain validation of claimed sales for resale via email. Form BOE-504-B1 is a sample letter the taxpayer may incorporate into an email and send to its purchasers. The letter provides instructions on how to transmit Form BOE-504-C1 via email. When returning Form BOE-504-C1 via email, the taxpayer’s customer must send it directly to the auditor with a copy provided to the taxpayer.](#)

[Forms BOE-504-A, B and C remain for use by taxpayers who prefer to mail XYZ letter inquiries to their customers.](#)

When it is appropriate to use the “XYZ” Letter process, the auditor will provide the taxpayer with a copy of forms BOE-504-A, B, and C (or -COS, -CLS, -CPA, -CFS or -CUS as appropriate). The auditor should discuss the “XYZ” Letter process with the taxpayer and explain that a response to an “XYZ” Letter inquiry alone is not necessarily enough to support a sale for resale. The auditor should also explain that since the “XYZ” Letter is not a substitute for a timely resale certificate, additional documentation or information may be required. Where the use of “XYZ” Letters is not advisable or appropriate, and the taxpayer insists on using the procedure, the taxpayer must be advised in writing that their customer’s response may not be accepted as verification of an exempt transaction.

A period of four weeks will be allowed for the taxpayer to prepare and send the “XYZ” statements and for the customer to reply. It is recommended that the “XYZ” statements be returned directly to the Board. If this is the case, the auditor should provide the taxpayer with return envelopes with the address of his or her district ~~branch~~ office. If the taxpayer elects to have the “XYZ” statements returned to them, the auditor should explain to the taxpayer that the likelihood of having staff contact the customer or sending an additional mailing is greater.

The taxpayer may customize the “XYZ” cover letter (BOE-504-B or BOE-504-BPA for special printing aids) by using the text contained therein on their own letterhead; however, the text in the sample letter should be used without additions, deletions, or changes. The taxpayer may ask their customers to forward payment of tax reimbursement if the transaction is identified as taxable. The statement should clearly state that the payment of tax be forwarded to the taxpayer and not the Board. All modifications to the cover letter must be approved by the auditor’s supervisor.

The “XYZ” statement (BOE-504-C, COS, CLS, CPA, CFS, or CUS) must be used as provided by the auditor. The use of a standardized “XYZ” statement will reduce any possible controversy over whether the proof provided is satisfactory. When verifying unique types of sales (e.g. printing aids, animal feed, fertilizer, etc.), auditor should provide the specialized forms to the taxpayer. The auditor should put his or her office designation in the space marked “DMA” and their initials in the space marked “Auditor’s Initials,” both located at the top right of the “XYZ” statements.

The taxpayer’s customer is requested to return the completed “XYZ” statement within 10 days. The 10-day requirement is intended to encourage a prompt response from the customer. If the taxpayer chooses the recommended procedure of having the completed “XYZ” statements sent directly to the Board, the taxpayer may add a statement in the letter (BOE-504-B) asking their customer to send a copy of the completed “XYZ” statement to them by fax or mail. The original “XYZ” statement, however, must either be sent or faxed to the Board by the taxpayer’s customer. If the completed “XYZ” statements are to be sent directly to the taxpayer, only a signed original will be accepted.

If a second “XYZ” Letter is necessary, the auditor should establish a reasonable period of time based on the circumstances involved.

As explained in section 0302.80, XYZ responses are part of the audit working papers and should be included as a subsidiary schedule to the resale examination schedule.

XYZ non-responses should not automatically be considered errors or non-errors. When XYZ responses are not returned, audit staff should make every effort, if not already done, to determine the taxability of the questioned sale by alternative methods. Such methods could include, but are not limited to:

- Examine the customer’s seller’s permit registration to determine whether or not the purchaser had a permit at the time of purchase, the type of business, reported sales, etc.
- Review the quantity and type of items sold – for resale or consumption.
- Review a subsequent resale certificate (prior to the start of the audit) ~~but~~ for similar purchases.
- Examine other types of items sold to the customer.
- Contact the customer by telephone to determine the true nature of the ~~sale~~purchase. If the customer indicates that the ~~sale~~purchase was for resale, a copy of the XYZ request letter should be faxed to the customer for immediate response. This XYZ response will be subject to the same verification as any other XYZ response.
- Accept or deny based on personal knowledge of the auditor gained from prior audits or other sources.

There are occasions when the taxpayer is unable to obtain an XYZ letter response because the customer is no longer in business due to a bankruptcy or other reason. In this situation only (not where there is just a change in ownership, such as a change in partners or from a sole proprietorship to partnership/corporation in which the previous owner continues the business under the new ownership), the sale will be considered a sale for resale if the property purchased by the customer is consistent with the type of sales the business makes. The auditor must verify file information regarding the close-out or bankruptcy of the business, as well as the type of business operations of the customer to ensure that the situation meets these specific requirements.

In all other situations, if the sale appears to be of a type that could be consumed, the taxpayer is unable to obtain a proper XYZ letter response, and the auditor is unable to determine the exempt status of the sale by alternative means, the non-response should be considered an error.

AUDIT PROCEDURE

0435.20

The MAP can be a valuable tool in streamlining the audit process. It is designed to reduce the time it takes to complete an audit and minimize the burden on taxpayers. When planning the audit, supervisors and auditors should evaluate whether the taxpayer is eligible for the use of a MAP. This evaluation should be conducted whether or not the taxpayer has already requested the use of a MAP.

It is primarily the responsibility of the auditor to determine whether a taxpayer should be considered for the MAP. However, it is the ~~The~~ auditor's immediate supervisor who is responsible for approval of the auditor's recommendation. If the taxpayer is eligible for use of a MAP, the auditor should discuss the MAP with the taxpayer as soon as possible rather than wait for the taxpayer to request using a MAP. The date of the discussion with the taxpayer and the taxpayer's response should be documented on Form BOE-414-Z. A decision that the taxpayer is not eligible should also be explained and documented on Form BOE-414-Z.

~~This information must be documented by the auditor on Form BOE 414-Z, Assignment Contact History.~~

EXAMPLES OF PRIOR AUDIT PERCENTAGE MEMOS

EXHIBIT 6

Page 1 of 2

State of California

Board of Equalization

Memorandum**To** : District Principal Auditor**Date:** December 1, 20XX**From** : Audit Supervisor**Subject** : Request to Use a Prior Audit Percentage ABC Company SR KH 12-345678

We would like to use a prior audit percentage in the current audit of ABC Company. Staff has reviewed their accounting procedures and determined that there has been no change since the last audit. In addition, there have been no changes to the personnel handling their accounts payable and there have been no changes to any laws or regulations affecting their business. The following is an outline of our proposal as specified in Audit Manual Section 0405.33:

- (a) ABC Company
SR KN 12-345678
- (b) The taxpayer is a manufacturer and distributor of consumer electronics.
- (c) The audit period is 1/1/00 - 12/31/02
- (d) The prior audit percentage would be used in the paid bills portion of the audit.
- (e) For the prior audit period, 1/1/97 - 12/31/99, the percentage of error was 2.01 percent.
- (f) For the prior audit period, 1/1/97 - 12/31/99, the population was \$4,100,000.
- (g) We propose the use of 2.01 percent in the current audit.
- (h) The population to which this percentage of error will be applied is \$5,600,000.

We have discussed this approach with the tax manager and she is agreeable to the use of the prior percentage of error. The tax manager was informed that this approach would not be used in consecutive audits. We both agree that given the relative consistency in the error rates, populations, accounting procedures, internal controls and personnel, the use of a prior percentage of error would save significant audit time while achieving substantially the same result as a new test.

Thank you for your consideration. Please let me know if you have any questions.

cc: I. M. Auditor

DELETED

AUDIT MANUAL

This memo is no longer required

(CONT.) EXHIBIT 6

Page 2 of 2

State of California

Board of Equalization

Memorandum

To : Chief, Tax Policy Division, (MIC: 92)

Date: December 1, 20XX

From : District Principal Auditor

Subject : Use of a Prior Audit Percentage

ABC Company SR KH 12-345678

We have completed our audit of ABC Company for the period of January 1, 2000 through December 31, 2002. The prior audit error percentage was used in the paid bills portion of this audit. The tax change resulting from the use of the prior audit error percentage is \$8,723. We estimate that a total of 40 audit hours were saved by utilizing this method.

Please let me know if you have any questions.

Attachment: December 1, 20XX Memo from Audit Supervisor to District Principal Auditor requesting use of prior audit percentage for ABC Company

cc: Chief, Field Operations Division
Equalization Districts 1 and 2
Out-of-State District (MIC 47), or

Chief, Field Operations Division
Equalization Districts 3 and 4
Centralized Collection Section (MIC 46)

I.M. Auditor